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Market volatility can create tax-smart opportunities

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Although periods of market volatility can often create investor anxiety, the gains and losses incurred during up and down markets can be leveraged to work together to minimize the taxes investors pay on capital gains. Through a practice called "tax loss harvesting," a savvy investor and wealth advisory team can strategically reduce federal tax liabilities without impacting long-term investment plans.

When you hold a security in a taxable investment account (e.g., not an IRA, Roth IRA, workplace retirement plan, or College Savings Plan), dividends, distributions, and sales can be subject to income tax. Complicating matters, each type of income may be subject to a different tax calculation.

Capital gain tax rates

Sales of investments are subject to "capital gains" taxes, and tax levels are based on how long you have held the investment. Capital gains (or losses) are the difference between the sale price of an investment and its purchase price.

1. If the investment is sold after being held for less than one year, it is considered a "short-term capital gain"
2. If an investment is sold after being held for one year or more, it is considered a "long-term capital gain"

Federal short-term capital gains are taxed at ordinary income tax rates; this is the tax rate you pay on your earnings (such as your salary at work) and retirement plan distributions. Long-term capital gains rates range from 0% to 20% based on your total taxable income.

Federal capital gain tax rates

Listed below are the 2024 Federal long-term capital gain tax brackets. [1]

Long-term Capital Gains tax rate	**Single filers (taxable income)**	**Married filing jointly**
0%	\$0–\$47,025	\$0–\$94,050
15%	\$47,026-518,900	\$94,051-583,750
20%	Over \$518,900	Over \$583,750

Many taxpayers are also subject to state income taxes on their capital gains.

You can offset taxes on capital gains by capital losses

The IRS allows investors to reduce the amount of capital gains subject to tax by the amount of losses they realize during year. These realized losses offset gains on a dollar-for-dollar basis, reducing the total tax burden. If losses exceed gains for any calendar year, up to $3,000 can be applied to other income (such as your earned income, retirement plan distributions or dividends) during the year. Unused losses are "carried forward" into future years until the total amount is realized.

Tax loss harvesting

Although periods of market volatility can often create investor anxiety, the losses incurred during down markets provide a unique planning opportunity called “tax loss harvesting.” During these “down market” periods, investors may be able to sell an investment at a price lower than the purchase price. Sale proceeds could then be redeployed to an investment that offers comparable market exposure or a similar risk/return expectation, while realized losses are used to reduce the taxes on other income.

Here’s an example:

A few months ago, an investor purchased $200,000 of a mutual fund that invests in large U.S. companies. Because of market volatility, this holding’s current market value is $180,000.

This individual had also realized a short-term capital gain of $5,000 on a sale earlier this year and she expects to receive $10,000 of long-term capital gain distributions from the mutual fund holdings in her taxable portfolio. She anticipates paying $2,700 in federal taxes because of these gains.

1. $5,000 short-term capital gain taxed as ordinary income (24%) = $1,200
2. $10,000 long-term capital gain distributions taxed as capital gains (15%) = $1,500

Our investor decides to execute a “tax loss sale” strategy by selling the mutual fund investment for $180,000 (realizing a short-term capital loss of $20,000) and immediately reinvesting the proceeds to another investment that also focuses on large U.S. companies. Since the dollars were exchanged for a similar investment at a similar price, the portfolio asset allocation remains unchanged. It is important to note that the investor has maintained their desired exposure to U.S. companies, so they have not “sold low” on the U.S. stock market.

The $20,000 tax loss is first used to reduce the investment gains. $5,000 of the loss is subtracted from her short-term capital gain of $5,000. She then reduces her long-term capital gains to $0 by applying $10,000 of her loss. After these calculations, a $5,000 "unused" loss remains.

Our investor then elects to apply $3,000 of this loss to her earned income from salary; at her 24% marginal tax rate, this saves an additional $720 of taxes. Finally, the remaining $2,000 loss is “carried forward” for use in future years.

In total, this strategy saved $3,420 in taxes this year (and will reduce some taxes in future years) without changing the portfolio mix.

The “wash sale” rule

It’s important to understand the impact of the “wash sale” rule. This IRS rule states that you cannot buy a “substantially identical” security as the investment sold for a loss within 30 days of the sale (either before or after the sale date). Investors can employ a few different strategies to comply with the wash sale rule.

- One alternative is to buy a similar (but not identical) investment as the security being sold. For example, a large U.S. company mutual fund could be replaced with a large U.S. company ETF on the same date as the sale.
- You could also realize a loss and wait more than 30 days until you replace the holding. After a sufficient amount of time from the date of the sale, you could reinvest the proceeds to the identical position if you choose. In this case, your portfolio is underweighted the targeted strategy for at least 30 days.
- Another strategy is to replace the identical security more than 30 days before it is sold. Here you identify the investment to be sold well before it is to be liquidated. You then buy an additional amount of this investment equal to the value of the shares you intend to sell. For at least 30 days, you hold both sets of investments (overweighting the position). After a sufficient waiting period, you then sell the first set of investments (the shares with the loss) and retain the second purchase.

This time of year is a great time to talk with your wealth advisor about how these strategies may help reduce your taxes. It’s important to understand that these strategies must be carefully applied and that other aspects of your individual circumstances may affect your intended outcome. Your wealth advisor can work with your tax professional to be sure that you achieve the desired result.

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1. https://www.mesirow.com/sites/default/files/PDFs/Wealth/2022-Contribution-Limits-web.pdf

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